Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT:CIN:1:POSTF-124977-02
JEBudde

date: Jul 26, 2002

to: Jeri King, International Examiner
Cincinnati, Ohio

from: Associate Area Counsel (LMSB)
Cincinnati, OH

---

subject: [redacted]
Section 902, [redacted]

This memorandum responds to your recent request for assistance. This memorandum should not be cited as precedent.

Issue

What is the correct methodology to merge E&P and foreign tax pools for Section 902 purposes when a foreign corporation with a negative E&P pool and a positive tax pool elects to be taxed as a partnership and is merged into a higher-tier foreign corporation?

Conclusion

Section 381(c)(2) answers the question by limiting the absorption of the accumulated E&P deficit so that it is available to the higher-tier foreign corporation only to offset E&P accumulated after the date of transfer. By extension, this same provision provides indirect support to challenge the taxpayer's computation of the foreign tax paid component of the 902 computation.

Background

The US taxpayer is [redacted] Inc. ([redacted]). [redacted] owns [redacted]% of a foreign corporation operating in [redacted], [redacted] owns [redacted]% of the stock of [redacted]. Prior to [redacted], [redacted] was treated for US tax purposes as a foreign corporation. Effective [redacted], by checking a box on Form 8832, [redacted] elected to be

classified as a partnership for US tax purposes. The change in classification from a corporation to a partnership triggered significant tax consequences. Prior to [redacted], [redacted] had accumulated a deficit in earnings and profits and also a large positive balance of foreign tax pools. After [redacted], [redacted] was no longer taxed as a separate entity for US tax purposes. [redacted] succeeded to [redacted]'s tax attributes. [redacted] pays dividends to [redacted] on a fairly regular, annual, basis. [redacted] would like to include the negative E&P pool and positive tax pool in its Section 902 computation of [redacted] as quickly as possible. The issue presented by your request involves how quickly [redacted] can use [redacted]'s E&P pool deficit and positive tax pool in its Section 902 computation.

The change in entity classification, itself, is a deemed liquidation of the [redacted] corporation and has tax consequences independent of Section 902. Sections 7701, 367 and related Code Sections (discussed below) describe the tax consequences of a liquidation of a foreign corporation. As you observe, the liquidation is of a foreign corporation into another foreign corporation.

On [redacted], [redacted] had an E&P pool balance of <$[redacted] and a tax pool of $[redacted]. [redacted] and its foreign subsidiaries use a June 30th year end. For the year ended June 30, [redacted], the E&P pool for [redacted] ([redacted]) was $[redacted] before any adjustment for [redacted]. No merger adjustment was made for the year ended June 30, [redacted]. The following year, [redacted] made the adjustments at issue. The Section 902 E&P computation began with the $[redacted] identified above, and was reduced by the <$[redacted] accumulated E&P amount of [redacted] for an adjusted E&P pool balance of $[redacted]. During the year ended June 30, [redacted], [redacted] earned $[redacted]. [redacted] made a dividend distribution of $[redacted]. [redacted] determined that it had an E&P pool balance of $[redacted] as of June 30, [redacted], as shown below.

[redacted], **E&P** Pool		[redacted] **Tax** Pool
Gen. limit non-PTI	$[redacted]	$[redacted]
Merger Adjustment	[redacted]	[redacted]
[redacted]		
Adjusted pool balance	[redacted]	[redacted]
FY[redacted]		
E&P adjustments	[redacted]	[redacted]

Pre-Distribution Balance	[redacted]	[redacted]
FY[redacted] Dividend Distribution	[redacted]	[redacted]
June 30,[redacted] Adjusted Pool Balance	$[redacted]	$[redacted]

The highlighted portion of the computation above is at issue. The taxpayer computed a Section 902 credit of $[redacted] The agent has reviewed the computation and has attempted to identify the dividend-numerator/[redacted] earnings-denominator and the foreign tax paid amount for [redacted] from the numbers above, without success. The agent has questioned the taxpayer about this computation. The taxpayer produced a binder which contains multiple computations and adjustments which ultimately reconcile to the Form 1118 foreign tax credit amount. The content of the binder cannot be reproduced, or even summarized, in this memo. In fact, I have not seen it. Nevertheless, the agent confirmed that [redacted] offset its E&P pool balance with the entire [redacted] E&P deficit for the year ended June 30, [redacted]. The agent has also determined that [redacted] immediately included all of the accumulated foreign tax pool of [redacted] for the Section 902 credit for June 30, [redacted].
The taxpayer willingly admits doing this.

On examination, the agent determined that the taxpayer's computation violated Section 381(c)(2) hovering deficit rule which allows a deficit in E&P of an acquired corporation to offset earnings and profits accumulated after (but not before) the date of transfer. The agent recomputed not only the E&P pool, but also the tax pools as follows:

[redacted], **E&P** Pool		[redacted] **Tax** Pool
Gen. limit non-PTI	$[redacted]	$[redacted]
Merger Adjustment	[redacted]	
[redacted] Adjusted pool balance	[redacted]	[redacted]
FY[redacted] E&P adjustments	[redacted]	[redacted]
Pre-Distribution Balance	[redacted]	[redacted]

FY [redacted]		
Dividend Distribution	[redacted]	[redacted]
June 30, [redacted]		
Adjusted Pool Balance	$[redacted]	$[redacted]

The agent's computation of the Section 902 credit totaled $[redacted]. The adjustment exceeds $23 million.

Adjustment: Sec. 902 per return $[redacted]
per audit [redacted]
$[redacted]

The agent's computation limits the use of the pre-merger [redacted] deficit to the post-merger E&P. The agent's computation impounds [redacted]'s tax pool until the pre-merger E&P pool deficit is exhausted. The agent points out that the computation is supported by the proposed regulations under Section 367 and by language of Section 381.

The agent proposed this FTC adjustment to the taxpayer. The taxpayer then refined the dispute. The taxpayer responded that the Section 367 regulations the agent cites for support were not proposed until after the year at issue and have not been made retroactive. As of this writing, these regulations remain in a proposed form. The taxpayer contends that it may compute the Section 902 credits to accelerate the potential 902 benefits resulting from the deemed transaction. The agent contends that the taxpayer is not free to compute the 902 credits however it wants. The agent seeks guidance on the issue in anticipation of the issue's inclusion in the RAR for the current cycle, which will soon close.

Law & Analysis

The source of the hovering deficit rule is statutory, not regulatory, and Section 381, which was in effect in [redacted] and [redacted] prohibits [redacted]'s methodology. Therefore, [redacted]'s computation of its Section 902 credit should be challenged.

[redacted] treated the change in [redacted]'s entity classification from a corporation to a partnership as a liquidation of the corporation. Pursuant to Treas. Reg. § 301.7701-3(g)(ii), if an entity classified as an association elects to be treated as a

partnership, the association is deemed to have distributed all its assets and liabilities in liquidation of the association and immediately thereafter, the shareholders are deemed to contribute all of the distributed assets and liabilities to a newly formed partnership. [redacted] is therefore deemed to have liquidated the corporation and formed the partnership in this way.

Section 332, which is titled, "Complete Liquidations of Subsidiaries", prescribes the tax treatment of corporate liquidations. Pursuant to Section 332, no gain or loss is recognized on the receipt by a US corporation of property distributed in complete liquidation of another corporation if the requirements of Section 332(b) are satisfied.

A different set of rules applies when the reorganization involves a foreign corporation. Section 367, titled "Foreign Corporations" provides a general rule that if a US person transfers property to a foreign corporation in connection with an exchange described in Sections 332, 351, 354, 356 or 361, then the foreign corporation would not be considered a corporation when determining the extent to which gain is recognized on the transfer. In summary, Section 367 revokes the nonrecognition treatment available for some domestic corporate restructuring. However, Section 367 does not apply when a foreign corporation receives a distribution in complete liquidation of another foreign corporation. In that situation, the foreign corporation will be treated as a corporation for purposes of Sections 332 and 381 and the transaction may qualify for nonrecognition treatment. The upshot of the journey through these tortuous provisions is that [redacted] is not required to recognize any gain from the deemed transaction caused by its checking the box.

The dispute instead centers on the carryover of the corporate attributes to the partnership. Section 381 is titled "Carryovers in Certain Corporate Acquisitions" and generally permits the acquiring corporation to absorb the earnings and profits (or a deficit in earnings and profits) of the acquired corporation, thus enabling "the successor corporation to step into the 'tax shoes' of its predecessor. However, a deficit in earnings and profits of either corporation can only be used to offset earnings and profits accumulated after the date of transfer. Section 381(c)(2)(B). On this basis, we agree with you that [redacted]'s computation of the E&P component of the 902 computation is prohibited. You have also contended that any taxes related to the deficit in E&P is impounded until the E&P accumulated after the transfer exceed the pre-transfer E&P deficit. Section 381 provides some indirect support for this position.

Section 381 applies to both domestic and foreign corporate acquisitions. The regulations which interpret the Section 381 provisions for transactions involving foreign corporations' earnings and profits and foreign income taxes, such as Section 902, have been issued under Section 367. Proposed Regulation § 1.367(b)-7 applies to an acquisition by a foreign corporation of the assets of another foreign corporation and addresses the computation at issue in this memo. Section (d)(2) of the regulation is titled, "Hovering deficit" and that portion of the regulation adopts the provisions of Section 381(c)(2) which prohibit the methodology used by [redacted] We note that the proposed regulation specifically delays the surviving corporation's use of foreign income taxes related to a hovering deficit until the entire hovering deficit has been exhausted. In our situation, the E&P deficit was not exhausted until years after [redacted]

This regulation was proposed on November 15, 2000, has been corrected during 2001, but has not yet become final. As a proposed regulation, the provision provides some information of how the IRS interprets the applicable statutes, but it does not carry the authority of a final regulation. The taxpayer contends that for the year in question, there was no regulatory guidance on how to compute the Section 902 credits. Therefore, its methodology must be considered reasonable and unassailable by the IRS.

While it is true that this regulation was not proposed until after the year in question, that matter of timing does not demonstrate the reasonableness of the taxpayer's computation. Even absent any regulation, the taxpayer must compute the Section 902 credit based upon the then existing law. The taxpayer's immediate use of the E&P deficit is prohibited by Section 381(c)(2). (b)(5)(AWP) [redacted]

Conclusion

We endorse the agent's challenge of the taxpayer's computation of the E&P pool. [redacted]

Should you have any questions about this memorandum, please contact John E. Budde at (513) 263-4857.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

RICHARD E. TROGOLO
Associate Area Counsel
(Large and Mid-Size Business)

By:_____
JOHN E. BUDDE
Senior Attorney (LMSB)